

**Before the  
FEDERAL COMMUNICATIONS COMMISSION  
Washington, D.C. 200554**

In the Matter of

Connect America Fund

) GN Docket No. 09-51

) CC Docket Nos. 01-92, 96-45

) WC Docket Nos. 10-90, 07-135, 05-337, 03-109

) WT Docket No. 10-208

**Reply Comments  
Of  
Fred Williamson & Associates (FW&A)  
On  
Rate of Return Represcription Staff Report**

Paul L. Cooper  
FW&A Consulting  
8282 S. Memorial Drive, Suite 301  
Tulsa, OK 74133

August 26, 2013

FW&A<sup>1</sup> hereby submits these Reply Comments in response to the Wireline Competition Bureau's (Bureau) May 16, 2013 Public Notice<sup>2</sup> seeking comment on a Bureau staff report<sup>3</sup>, about represcribing the 11.25% authorized rate of return for Rural Local Exchange Carriers (RLECs).

### **THE CURRENT 11.25% RATE OF RETURN SHOULD BE MAINTAINED**

It is clear from a review of the comments filed in this proceeding that the current Rate of Return (RoR) of 11.25% should be maintained and continued into the future for RLECs until a proper evaluation by the Commission can be made.<sup>4</sup>

Although the Staff Report provided a detailed analysis, that analysis was flawed and does not support a revision of the RLEC RoR.

#### **A. The Use of Publicly Traded Companies As a Proxy for RLECs Leads To Unrepresentative Results.**

As the Rural Telephone Finance Company (RTFC) correctly points out in its Comments in this proceeding, "...the return and risk profile of these companies bear little resemblance to the financial, business, and regulatory challenges facing non-publicly traded RLECs."<sup>5</sup> Further the RTFC as a lender to RLECs indicates that the current return of 11.25% may be inadequate because, "...their risk profiles may exceed those of companies like AT&T and Verizon...RTFC questions whether the existing rate of return of 11.25% is adequate given the risk inherent in the

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<sup>1</sup> FW&A is a consulting company providing regulatory and financial services to RLECs.

<sup>2</sup> Wireline Competition Bureau Seeks Comment on Rate of Return Represcription Staff Report, Public Notice released May 16, 2013 (Public Notice).

<sup>3</sup> Prescribing the Authorized Rate of Return: Analysis of Methods for Establishing Just and Reasonable Rates for Local Exchange Carriers, WC Docket No. 10-90, Staff Report released May 16, 2013 (Staff Report).

<sup>4</sup> At odds with the assertions made by The National Association of State Utility Consumer Advocates (NASUCA), the years since the RoR was set at 11.25% provides no valid justification for its revision, nor is it correct that: "...the levels of rural carriers' USF funding has long been calculated at a level based on an excessive RoR..." (See page 5 on NASUCA's comments). Likewise, the National Cable & Telecommunications Association (NCTA) comments at page 4 that rural ILECs have received a massive windfall from the current RoR are unfounded and without any basis in fact.

<sup>5</sup> Comments of the Rural Telephone Finance Company at page 2.

rural telecom industry today.”<sup>6</sup> Alexicon at page iii of its comments also indicates that: “RoR ILECs have significantly more risk than the proxy group composed of Regional Bell Holding Companies, Mid-Size Price Cap Carriers and Publicly Traded RLECs.”

RTFC and Alexicon are correct in their observations. Unlike price cap LECs, RLECs generally serve only rural, high cost, low customer density areas. As a consequence, even before the implementation of the Universal Service Fund (USF) reforms introduced by the National Broadband Plan, revenue losses due to competitive alternatives, intercarrier compensation arbitrage and the cap on the existing High Cost Loop Fund often placed these companies in highly vulnerable, precarious and uncertain financial circumstances. In order to retain customers and compete in this environment, RLECs must deploy high-speed broadband services that required large amounts of capital to provide facilities that could deliver broadband to their customers. Acquisition of this capital increased the RLECs’ risk exposure, but network upgrades are essential to remain a viable enterprise.

Because RLECs served low customer density areas, customer revenues fall far short of revenues needed to provide service. As a consequence, RLECs are heavily dependent on USF and intercarrier compensation revenue. However, the USF reforms introduced by the National Broadband Plan (an overall cap and regression cap on funding, phase out of intercarrier compensation and local switching support revenue, etc.) have constrained or eliminated these revenues.<sup>7</sup> This has further increased the risk that RLECs would not have sufficient revenues to pay for the loans necessary to upgrade facilities to provide broadband access, provide an adequate (or even a modest) return on equity or even in some cases to continue as a viable enterprise.

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<sup>6</sup> Id., page 4

<sup>7</sup> See also comments of The Eastern Rural Telecom Association at pages 6 to 9.

Generally the proxy carriers used in the Staff Report (in particular large price cap carriers) have none of the risks faced by RLECs:

- Although these carriers also serve rural high-cost, low-density areas, their risk of revenue loss due to market competition can be averaged across their entire enterprise which includes urban low-density customer areas and other profitable businesses such as wireless.
- Generally large price cap carriers internally generate the capital to upgrade their networks and do not, (as do RLECs) need to face the risk of borrowing those funds on the capital markets. At odds with this, RLECs cannot internally generate the required capital, and because of their increased risks, face a reduction in capital access.<sup>8</sup> Further, RLECs are curtailing capital deployment and needed network upgrades because of the risk that they could not repay the loans for that capital. This further increases their exposure to competitive losses because they cannot offer services desired by consumers.
- Larger price cap carriers did not (as did RLECs) expend resources to upgrade their networks for their rural customers, but instead, used their rural areas as “cash cows” to generate revenues to deploy services in urban areas, wireless operations and to increase returns to stockholders. The USF reforms of the National Broadband Plan do not constrain USF funding for these carriers (as is the case for RLECs) but instead gives these carriers additional funding so that they can now provide broadband access in the rural areas that they have long neglected.

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<sup>8</sup> See comments of The Alaska Rural Coalition at page 7 where they discuss CoBank and RUS concerns regarding the ability of RLECs to meet lending standards to borrow for capital improvements.

It is clear that the market and revenue loss risks faced by price cap carriers and the proxy group of carriers used by the Bureau in the Staff Report is in fact less than the risks faced by RLECs today. As a consequence, these proxy carriers are a poor and in fact, unrepresentative choice for estimating the RLECs' cost of capital.<sup>9</sup>

## **B. Further Study Is Required To Determine If The RLEC RoR Should Be Revised.**

The above discussion makes it clear that (a) publically traded companies, face less risk than RLECs, (b) are an unsuitable proxy to determine RLECs cost of capital, and (c) in the current environment faced by RLECs, the current RoR of 11.25% may be too low.

As the Association's Comments correctly point out: "Common sense suggests that an investor familiar with today's telecommunications business environment would not put dollars in an RLEC when he or she could expect the same or *higher* return in an RHC (or some other entity that had diversified operations in larger markets with more enterprise customers)."<sup>10</sup>

When or if a proper analysis of RLEC RoR requirements is conducted by the Commission, it should:

- Not rely on methodologies that use "...short-term perspectives at a time when interest rates have been dramatically reduced by Federal Reserve policy designed to combat the Great Recession...".<sup>11</sup>

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<sup>9</sup> See also comments of the National Exchange Carrier Association, Inc.; NTCA – The Rural Broadband Association; USTelecom; Eastern Rural Telecom Association; and Western Telecommunications Alliance (Association Comments).

<sup>10</sup> Id., page 4.

<sup>11</sup> Comments of the Rural Telephone Finance Company at page 3. See also comments of the Eastern Rural Telecom Association at page 5 where they correctly note that: As the Eastern Rural Telecom Association notes in its comments at page 5, "As the economy continues to improve and gain strength, it can be expected that both short term and long term interest rates will rise." As a consequence, the Commission should not rely on the current artificially low interest rates.

- Properly take into account the market and revenue risks faced by RLECs. The Commission should use a method that uses data from a representative sample of RLECs (as proposed by the Associations) rather than unrepresentative proxy companies.
- Account for the fact that the current return of 11.25% has been used by RLECs to justify loans made with the Rural Utilities Service. Lowering that return will put at risk the revenues necessary to repay these loans.

**C. Conclusion.**

Until a proper evaluation of the RLECs' RoR can be made by the Commission, the current 11.25% return should not be changed. The Staff Report provides no basis to revise the current RoR.

Respectfully submitted,

Paul L. Cooper  
President  
FW&A Consulting  
8282 S. Memorial Drive, Suite 301  
Tulsa, OK 74133  
918-298-1618

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August 26, 2013